

FTA Survey of Services Taxation - Update

Few issues stoke the political fires more than taxation of services. In order to assist policymakers and tax policy researchers in this area, FTA conducted a survey of service taxation in 1990. The survey has been updated periodically, last in 2004. This article presents preliminary data on the latest update, services taxed as of July 1, 2007.

FTA sent a list of 168 different services and asked states to list the taxable status of each service. A tax official in the state specified whether the sales tax applied, a special excise or gross receipts tax applied, or whether the service is exempt from taxation. Space was also provided for the official to describe exceptions and include notes to clarify the status. Users should note that the list of services in this survey is not a comprehensive list of all services that can or should be taxed. The list was selected to identify different categories in order to provide researchers with a picture of how much each state taxes services. The preliminary results are summarized in the table on the next page. FTA received responses from 42 states and the District of Columbia. For states not responding, the 2004 responses are used in this table.

The results of this update illustrate that most states tax services to a certain degree. Despite the political rhetoric, there are many services that do not pose controversy and are widely taxed. As the table illustrates, utility services are taxed in most all states. Also, admissions and repair services are taxed in many states. On the other hand, fewer states tax personal and business services. Professional services (doctors, lawyers) are taxed in only 7 states.

Only Hawaii and New Mexico have broad-based sales taxes that include most all the services (160 and 158, respectively) tracked by the survey.

Delaware and Washington tax a large number of services, mainly through their low-rate business gross receipts taxes. South Dakota and West Virginia are the only other states to tax more than 100 services. These states and Texas, which taxes land surveying, are also the only states to tax any of the 9 professional services tracked by the survey.

When comparing the 2007 results with the 2004 survey, we find that very little has changed in the level of state service taxation

Several other states tax a large number of selected services. These include Arkansas, Connecticut, District of Columbia, Iowa, Kansas, Mississippi, Nebraska, New Jersey, Texas, and Wisconsin. These states widely tax utilities, admissions/amusements and labor and repair services, but leave professional services largely untaxed. Of these states, Connecticut, District of Columbia and Texas tax more computer service than is the norm for most states. Also, Connecticut taxes more business services while Iowa taxes more personal and business services than others in this group.

Changes Since 2004

When comparing the 2007 results with the 2004 survey, we find that very little has changed in the level of state service taxation. The strong economy and good state finances have led policymakers to be reluctant to impose tax increases or new type of taxes. Only New Jersey enacted legislation to expand the taxation of services. Maryland and Michigan also enacted legislation to tax additional services but legislation in these states was repealed before implementation.

Facing a budget deficit in 2006 and a need to provide local property tax relief, New Jersey lawmakers enacted a tax package that included an increase in the sales tax rate and broadened the base to include more services. Some of the services included in the tax base include storage, tanning and massage services, limousine services and information services. This raised the number of taxable services from 55 services in 2004 to 74 services in the current survey.

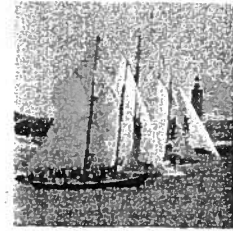
Also facing a budget deficit, Maryland lawmakers in a 2007 special session enacted a tax package that increased sales and income taxes and extended the sales tax to computer services. After much debate, the sales tax expansion to services was repealed before the July 2008 implementation date, with an income tax surtax replacing the revenues.

As part of the state's effort to restructure its business taxes, Michigan's legislature expanded the sales tax to include 23 services, effective December 1, 2007. Some of the services included in the legislation were business service center services, consulting and investment advice services, janitorial and landscaping services, warehousing, packaging, procurement services and many personal services such as concierge and psychic services. The service tax was repealed on December 1, 2007, with a business surcharge imposed to replace the revenue.

The FTA work on the taxation of services is intended to assist state tax administrators and others in assessing the potential for and the implication of taxing services. This 2007 update provides a more current picture of who is taxing what. A [preliminary spreadsheet](#) with the data is available on [TaxExchange](#), and more information will be available soon on the [FTA Home Page](#).

Have You Made Your Hotel Reservations? The Annual FTA Revenue Estimating and Tax Research Conference will be held September 14-17, 2008, at the Holiday Inn By the Bay in Portland, Maine. Conference and Hotel Registration are available on the conference website http://www.ftaxadmin.org/rev_est/.

The Deadline for hotel reservations was August 12. If you have not made reservations, call the hotel as soon as possible at 1-800-345-5050 to make your reservations. Tell the reservation agent that you are attending the FTA conference.



Number of Services Taxed by Category and State - July 2007

	Utilities	Personal Services	Business Services	Computer Services	Admissions/ Professional Amusements	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Alabama	12	2	6	3	10	0	1	3	37
Alaska *	0	0	0	0	0	0	0	1	1
Arkansas	16	7	12	1	12	0	11	13	72
Arizona	12	2	7	0	9	0	2	23	55
California	2	2	7	2	1	0	3	4	21
Colorado *	4	0	2	1	2	0	3	2	14
Connecticut	10	9	20	6	10	0	10	14	79
Delaware *	9	20	33	6	10	9	19	37	143
District of Columbia	13	7	15	6	8	0	12	12	73
Florida	7	4	9	0	14	0	16	13	63
Georgia *	10	4	5	2	8	0	1	6	36
Hawaii	16	20	34	8	14	9	18	41	160
Iowa	13	15	18	1	14	0	13	20	94
Idaho	0	3	5	0	11	0	6	4	29
Illinois	12	1	1	1	0	0	1	1	17
Indiana	7	4	3	2	3	0	1	4	24
Kansas	10	11	9	1	13	0	1	15	74
Kentucky	11	2	4	0	6	0	4	1	28
Louisiana	10	8	5	3	9	0	13	7	55
Maine	9	1	6	0	3	0	4	2	25
Maryland	5	3	13	1	11	0	4	2	39
Massachusetts	9	1	4	0	1	0	2	1	18
Michigan	12	2	7	1	1	0	1	2	26
Minnesota	15	7	12	2	13	0	6	11	66
Mississippi	10	5	8	3	11	0	13	22	72
Missouri	8	1	2	2	10	0	0	3	26
Montana	12	0	0	0	2	0	0	4	18
Nebraska	14	9	14	3	12	0	13	12	77
Nevada	0	1	4	0	7	0	2	4	18
New Hampshire *	6	1	0	2	0	0	0	2	11
New Jersey	12	5	16	1	6	0	15	19	74
New Mexico	16	20	32	8	14	9	18	41	158
New York	4	4	13	1	6	0	14	15	57
North Carolina	10	4	5	0	9	0	1	1	30
North Dakota	6	1	4	2	11	0	0	2	26
Ohio	8	12	14	5	3	0	12	14	68
Oklahoma	9	3	4	1	10	0	0	5	32
Oregon	0	0	0	0	0	0	0	0	0
Pennsylvania	9	5	16	1	1	0	15	8	55
Rhode Island *	10	1	6	3	4	0	3	2	29
South Carolina	4	6	7	4	10	0	1	3	35
South Dakota	14	19	28	8	13	5	18	41	146
Tennessee *	11	10	7	3	12	0	13	11	67
Texas	12	10	14	8	12	1	10	16	83
Utah	7	8	6	0	11	0	15	11	58
Vermont	9	2	5	2	11	0	2	1	32
Virginia *	1	3	4	0	1	0	4	5	18
Washington	16	20	33	8	13	9	16	43	158
West Virginia	6	17	26	4	13	1	13	25	105
Wisconsin	11	11	8	3	14	0	14	15	76
Wyoming	10	6	6	2	6	0	16	12	58
Total Number in Category	16	20	34	8	15	9	19	47	168

* State did not respond, 2004 data reported
Source: FTA survey

Should Sales Taxes Apply to Services?

General sales taxes are an important revenue source for state governments, accounting for close to a quarter of state tax collections nationwide. But these taxes have a potentially damaging structural flaw: the tax typically applies to most sales of goods, such as books and computers, but exempts services such as haircuts and car repairs. This omission is not the result of conscious policy choices, but a historical accident: when most state sales taxes were enacted in the 1930s, services were a relatively small part of consumer spending. In recent years, however, spending on services has skyrocketed: in 2007, services represented almost 60 percent of personal consumption nationally. Few states have successfully adapted to this change in consumption: only Hawaii, New Mexico, and South Dakota tax services comprehensively, and the Federation of Tax Administrators estimates that only nine states tax more than half of the services that are potentially taxable. This policy brief surveys arguments in favor of taxing services—and assesses potential pitfalls in attempts to tax services.

Taxing Services = A Fairer Tax

Sales taxes generally create two types of unfairness in the tax code—and taxing services can help eliminate each of them. First, sales taxes are *regressive*, requiring low-income taxpayers to pay more of their income in sales tax than wealthier taxpayers. Second, sales taxes generally include a wide variety of special exemptions, which often discriminate between similar taxpayers in ways that are not defensible from a tax fairness standpoint. Exemptions for services are a good example of this sort of unfairness: exempting services discriminates against individuals who consume more goods than services. The first type of unfairness is called *vertical equity* because it compares the treatment of taxpayers at different income levels; the second type is called *horizontal equity* because it compares the treatment of taxpayers at the same income level.

Taxing services can help to reduce each of these problems. Expanding the base to include personal services results in a slightly less regressive sales tax compared to a goods based tax because many of these services are consumed disproportionately by wealthier taxpayers. And treating consumer services the same way as consumer goods will eliminate discrimination in the tax code between goods-consuming and service-consuming taxpayers.

Taxing Services Will Not Eliminate Unfairness

However, the fairness gains from taxing services are likely to be limited in practice. First, low-income taxpayers spend more of their income than do wealthier taxpayers, who are more likely to be able to save some income. No expansion of the tax base is likely to change this basic relationship between consumption and income. Second, the impact of taxing services on tax fairness can vary depending on which services are taxed. Taxing services such as housing, utilities, and other necessities can actually make the sales tax more regressive because these services are basic staples of consumer spending, not high-end luxuries. And it may be politically more difficult to tax services consumed by the wealthy than to tax services consumed by low-income taxpayers.

Taxing services can also have a negative impact on fairness if the services taxed include services consumed by businesses. Economists agree that items purchased by

wholesalers for resale, and items purchased by businesses for use in producing other products, should not be taxed. Legal and accounting services are examples of "business to business" transactions. Taxing these services will make sales taxes more unfair because "business to business" sales taxes are ultimately passed through to consumers in the form of higher prices. These passed-through taxes are invisible to the consumer, and have unpredictable effects on tax fairness (since the amount passed through depends on the number of stages of production that were taxed). For this reason, sales tax base expansion efforts should focus on services that are consumed by individuals rather than businesses.

Taxing Services = Higher Revenue and Faster Growth

As a practical matter, state policymakers see taxing services as a desirable policy option because it allows states to increase tax revenues in the short run without increasing tax rates. Expanding the tax base to include more services will increase the amount of taxes collected for each percentage point of the sales tax rate—a critical consideration in states where increasing tax rates is politically difficult. But taxing services will also pay long-term dividends: as consumers spend more of their income on services, states taxing these services will see faster growth in sales tax revenues. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of consumption will be offset by gains in another area. In other words, adding services to the tax base helps achieve adequate revenues in both the short run and the long run—and will be satisfactory to both political leaders and economists.

Approaches to Taxing Services

Lawmakers seeking to expand the sales tax base face three policy choices: which services to tax, whether or not to couple any base expansion with a cut in the tax rate, and whether to provide targeted tax relief to partially offset this regressive tax hike.

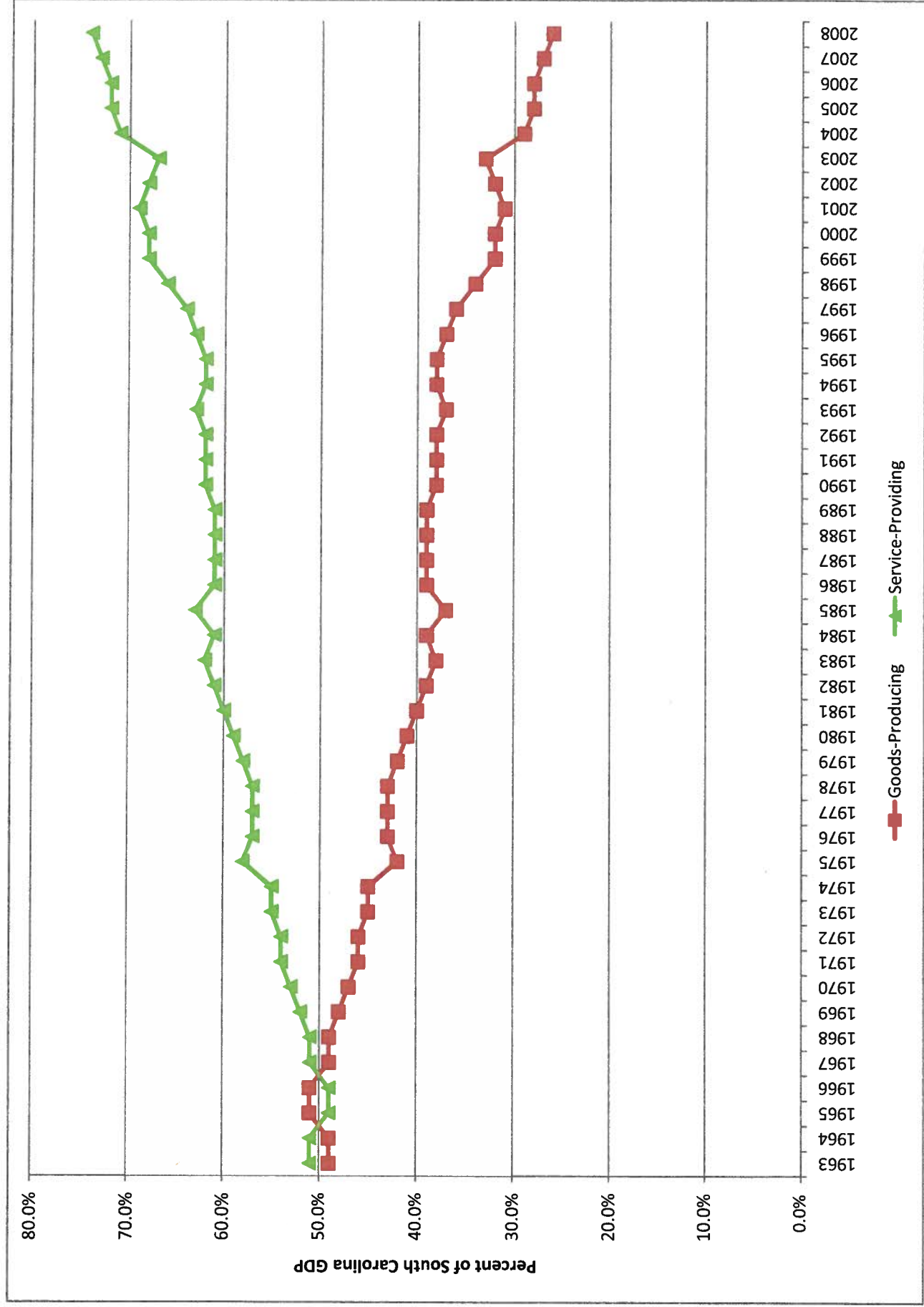
Expanding the sales tax base will increase tax revenues if no other changes are made. However, if raising new revenue is not an immediate goal, combining a sales tax base expansion with a tax rate reduction can be an appropriate step. A "revenue-neutral" tax change of this kind, which expands the tax base and reduces the sales tax rate to leave total sales tax collections unchanged, will likely result in higher tax revenues over the long run, since consumption of services generally grows faster than consumption of goods.

One way to reduce the regressive impact of taxing services is a targeted tax credit. Twenty-three states and the District of Columbia now allow an Earned Income Tax Credit, designed to reduce taxes on low-income working families, and a few states allow sales tax credits, designed to offset part of the sales tax liability on low-income taxpayers. Either approach will provide targeted tax relief to those most affected by regressive sales taxes, at a relatively low cost to the state. (*ITEP Policy Brief #14 discusses options for sales tax relief, and Policy Brief #15 discusses the Earned Income Tax Credit.*)

Conclusion

Taxing services is attractive to policy makers because it allows revenue-raising without highly-visible increases in tax rates, and is attractive for consumers because it avoids discriminating between taxpayers. When properly done, expanding the tax base is simply good policy: taxing services can make sales taxes less regressive, less discriminatory and more responsive to economic growth. But sales taxes remain regressive—which means that provisions for low-income tax relief through an Earned Income Tax Credit or sales tax credit may be appropriate.

Goods/Services in GDP South Carolina



Personal Consumption Trends United States

